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The Dwindling Profits Fuse

> **"The possible growth of debt is a direct function of the growth of production. If production ceases to grow, automatically the debt ceases to grow...It looks as if we were suffering from overproduction of debt, not overproduction of goods."**
>
> **— Basset Jones, Debt and Production**

In the U.S. profits are slumping, corporate investment is dwindling, and the current account deficit is growing. In Europe wages are only now showing marginal flexibility, unemployment remains at record highs, and fiscal profligacy is pervasive. Yet, Wall Street is on its way to the best year in an unprecedented five-year bull market and Europe's exchanges are handily outperforming the U.S. And no one seems particularly concerned. What gives?

What gives is that everywhere financial analysts and other professional optimists are now programmed to ignore all bad news and focus only on the "positives". The trouble, however, is that the supposed positives are really only the bubble effects of a global liquidity flood. Declining budget deficits, soaring stock markets, and booming consumption in this decade all have as their root cause a sea of loose money which has brought on a dramatic reduction in interest rates. This, of course, is not sustainable. But the professional optimists continue to take these supposed virtues at face value, never examining their causes and sustainability.

We, however, are compelled by training and inclination to examine the global economy fundamentally, not superficially. In this letter, we address Europe's key structural weaknesses — wage excesses and capital consumption caused by rampant fiscal spending. With these fundamental flaws in mind, we assess the outlook for Europe's financial markets and the euro. We find a collapse of exports to Asia and a flood of imports from Asia curtailing Europe's export-led recoveries and threatening the bull markets. We also find that the euro will likely be strong at the outset, but it will be an ephemeral strength — as perishable as the enthusiasm now driving the markets.

In the U.S., we explain why sagging profits and investment and a booming current account deficit are making the bubble economy and stock market more vulnerable than ever. We also discuss why we do not join the camp that minimizes the negative effects of the Asian crisis on the U.S. and Europe. On the contrary, we find significant cause for concern, including the recent advent of net selling of U.S. Treasuries by foreigners.

EURO EUPHORIA

Surely by now you have heard talk of a supposed "New Paradigm" of the U.S. economy, which is delivering strong growth and high profits without inflation in perpetuity. Now get ready for the very same blather about EMU-land. Looking at the unequaled surge in Europe's bond and stock markets, investors are apparently betting that the euro party, to start next January 1, will prove a smashing success. Remarkably, European bond and stock markets have been persistently outperforming Wall Street this year.

There are certainly other factors beside the euro driving the investment surge in Europe. One prominent theme in the media is that European corporations are moving toward Anglo-Saxon capitalism and equity culture, making the maximization of shareholder wealth the primary aim of management. An unprecedented merger and restructuring frenzy is uncritically interpreted as a strenuous drive to eliminate inefficiencies and economize on size. At the same time, an increasing number of average Europeans are becoming avid stockholders. For some observers, this is the United States of three or four years ago.

But this is not merely a replay of the American bull story in Europe. Instead, the larger story in Europe stresses economic gains to be reaped from sharing a common currency across borders: more transparent prices, enhanced competition, lower transaction costs, and much broader financial markets. The European Commission has put the resulting gains at 0.5 percent of GDP annually. Moreover, the euro area's bond markets will rival America's in size, and so will its stock markets.

	— 1998 Forecasts —			% Chg. in Stock Prices during
Country	Real GDP Growth	Unemployment	Inflation	First Quarter 98
United States	2.6	5.0	1.7	15.23
Germany	2.7	11.4	1.7	20.30
France	2.7	11.9	1.0	26.32
Italy	2.2	12.0	2.1	42.11
Spain	3.6	19.7	2.2	41.83
Portugal	3.8	6.6	2.2	45.46
Ireland	7.3	9.3	3.3	26.58
UK	1.7	4.9	2.3	16.97

Except for naggingly high unemployment, it would seem that the euro party could hardly have started in a better environment.

EMU-land has come close to price stability. Long-term interest rates have converged across Europe downward to the low levels of the hard-currency countries, bolstering profits and valuations in their markets. For the time being, the European corporate profit boom remains on track, while U.S. corporations are on the verge of a profit squeeze. At the same time, the record-low short- and long-term interest rates have persuaded investors to switch out of low-yielding bank deposits and bonds into the booming equities. Budget deficits, even considering some fudging of the numbers, appear tamed. Whatever the validity of these arguments, the financial markets clearly like the euro. And this essentially suggests that the euro will be strong — at least until the appearance of some negatives that the markets dislike.

We have repeatedly expressed our misgivings about economic developments in Europe, with or without a common currency. Europe's core problems are the exorbitant size of government spending and sclerotic labor laws, and there is absolutely nothing in EMU telling governments to reduce their share of GDP or to reform their rigid labor laws. Germany has actually gone ahead recently and raised its value-added tax. Meanwhile, the seemingly tight Maastricht criteria for admittance to EMU were judiciously fudged. As explained in the last letter, much of European governments' widely-hailed "fiscal restraint" in recent years has come from easy windfall gains through plunging interest costs in government budgets, not from painful spending cuts.

THE WAGE DILEMMA

The one positive aspect of recent economic development in Europe is a general moderation in wages, after decades of wage excesses. At long last, the high unemployment rates are putting a damper on wage demands and settlements. Without any question, it is a step in the right direction. Yet for economic growth it is in the short run a double-edged accomplishment because wages play a dual role in the economy. For businesses, they are a most important cost factor. But for the economy as a whole and the mass consumers, they are the main source of income and purchasing power.

Which of the two effects is decisive for economic growth, the effect on business costs or the effect on consumer purchasing power? Traditionally, economists have stressed the impact of changes in wages on costs, and thereby on profits, because the latter, in turn, motivate investment and employment. Typically, businesses used to respond to economic downturns with wage cuts.

The first explicit repudiation of this principle occurred in the United States at the outbreak of the Great Depression. When it struck, heralded by the stock market crash of late October 1929, President Hoover's first act was to call a series of White House conferences with the leading industrialists and financiers of the country, imploring

them to maintain wage rates. Hoover insisted that in the interest of maintaining consumer purchasing power, the first shock of the depression must fall on profits and not on wages — precisely the reverse of past policies.

This idea that high wages bolster employment and economic growth by creating consumer purchasing power had in the course of the 1920s gained wide circulation in the United States. Its origin lies with two men, Messrs. Foster and Catchings, whose books and teaching swayed many "big" businessmen in America — among them Henry Ford — toward this "progressive" and "enlightened" idea. Later, American Keynesians appropriated and embellished it with the postulation of the so-called acceleration principle. When Herbert Hoover became U.S. President in 1929, he had long been an ardent advocate of this doctrine. President Roosevelt was to continue this policy in his "New Deal."

In the rest of the world, this concept of increasing demand for goods and services through higher wages found favor in just one other country — from 1936 on in socialist France. In each case, this policy of high wages was accompanied by heavy public deficit spending. In both countries, the two policy stances proved a blatant failure. When the war broke out in 1939, France and the United States were the only major countries that had failed to regain the 1929 level of employment and production. As John Kenneth Galbraith has commented, the Great Depression did not, in fact end. It was swept away by World War II.

THE OTHER ROOT CAUSE OF MASS UMEMPLOYMENT: CAPITAL CONSUMPTION

Back to the present situation in Europe. Wage moderation is absolutely essential to improve employment. But it has to be realized that instant positive employment effects cannot be hoped for. And before the employment rolls can rise, consumer incomes and purchasing power tend to drop. In Germany and France, with unemployment still on the rise until very recently, the wage moderation has rather intensified the prevailing sluggishness in consumer spending. Considering that private consumption accounts for two-thirds of GDP, the ensuing wage squeeze was certainly crucial in keeping economic growth depressed.

It has taken three decades of wage and fiscal excesses to drive Europe's unemployment rate from two to 12 percent. Clearly, maladjustments that have accumulated over such a long period cannot be undone by two or three years of wage restraint. No quick fix is available.

In the final analysis, wage excesses are only one of the two root causes of Europe's unemployment malaise. The associated fiscal excesses are the other root cause. These excesses have progressively ravaged (crowded out) capital formation and investment ratios. Inexorably, the wage and fiscal excesses have reinforced each other in their long-term destructive effect on employment and economic growth.

Employment is dependent on capital. Accommodating high and rising wage levels together with full employment requires correspondingly high capital formation, more precisely, investment per head. But with their spending and borrowing binges, Europe's governments have systematically decimated the capital formation in their countries. The striking hallmark of this ongoing process of capital consumption is the relentless rise in government spending to 50 percent of GDP and a concurrent sharp decrease in gross fixed capital formation from 23 percent to 18 percent of GDP.

In America, wage policy took the opposite route. It is the secret of the well-functioning U.S. job machine that in the 1970s, when U.S. savings and investment rates went into structural decline, wage increases promptly adjusted downward. While economic growth slowed down, the economy became more labor-intensive, essentially at the expense of productivity gains. Most of the time since then, wage rate rises have lagged inflation rates, entailing a long-term decline in real wage rates. To quote an old German economist on this point: Even countries with miserly capital formation may have full employment, provided that the wage earners acquiesce in wages that conform to low investment per head and accordingly low productivity gains.

With 12 percent of the labor force now idle, wage moderation has finally arrived in Europe too. Paradoxically, though, neither the politicians nor the electorates are ready for any pain in the form of cuts in the bloated welfare systems. Again, Germany and France seem the most inflexible in this respect. Existing job-killing taxes and social contributions as well as labor market rigidities are hardly touched. Fiscal restraint was and remains a farce.

What we presently see in Europe is a cyclical recovery, but without sorely needed structural reforms. Disturbingly, employment gains during upswings increasingly fall short of the employment losses in previous downturns. For reasons explained in the last letter, this phenomenon has been particularly pronounced in the current recovery in Germany and France. Moreover, the recovery has been extremely unbalanced, being overwhelmingly due to booming exports in core Europe.

THE FIRST EMU HEADACHE

Given low inflation all around and accelerating growth in Europe, a smooth transition towards EMU seems assured. Still, there is an unexpected headache. The cyclical positions of the member countries are grossly out of synch. Europe's peripheral states (Spain, Portugal, Ireland and Finland) have rapidly growing economies which ought to be cooled down with higher interest rates, while the core economies, among them Germany and France, are still in a funk and need to keep interest rates low. Apparently, this momentum in the periphery is the response of these economies to the steep fall of interest rates over the last two years. Ireland, with eight percent real GDP growth and its money market 350 basis points above the French/German rate, is most awkwardly placed.

But a common currency implies one single money market rate, set by the central bank for the whole area regardless of divergent regional needs. Whose interests will prevail? Those of France and Germany? It is expected that they will offer only a token rise of their repo rates by perhaps 30 basis points, forcing Ireland, Italy, Spain and Portugal to make substantial cuts, despite their booming economies.

As for Europe's ongoing cyclical recovery, the conventional wisdom holds that it will both broaden and accelerate, increasingly powered by strengthening domestic demand. We wonder. We see core Europe's export boom coming sharply off the boil, as the Asian slump begins to take its toll. Already, the adverse trade repercussions are proving far worse than the professional optimists had earlier predicted.

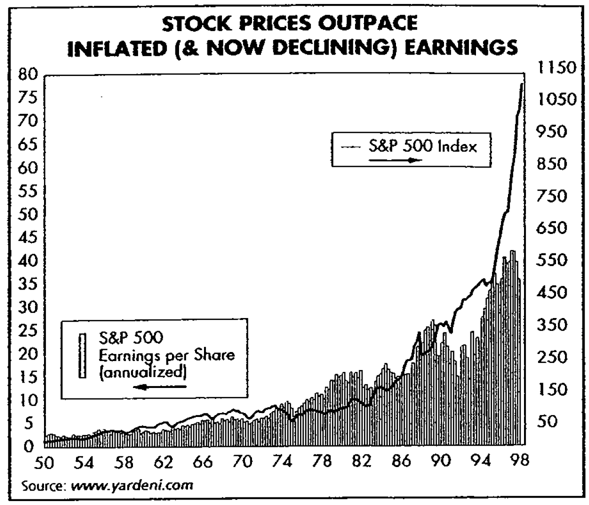
The prevailing false complacency about the Asian crisis has above all been based on the argument that trade with these countries accounts only for a tiny fraction of total U.S. or European GDP. Yes, but compared with 2-3 percent current GDP growth in the industrial countries, that fraction emerges instead as a millstone of potentially crushing weight. While the deleterious Asian impact on the region's imports will intensify in coming months, the impact of sharply higher Asian exports has yet to be felt to any degree.

TWO KEY SURPRISES

The first big, unpleasant surprise in 1998 among the industrial countries is the hammering of Japan's economy. Collapsing Japanese imports are now joining with collapsing imports of the Southeast Asian countries. The next industrial economy to be badly hit by the Asian slump will most probably be the U.S. It happens that this assumption of ours finds support in the most recent projections of the international organizations (OECD and IMF) for the US current account, which show a soaring deficit over the next two years.

A far more important, though still looming, surprise for 1998 may be a sharper-than-expected U.S. economic slowdown and a falling dollar. If it happens, it will have shattering effects on the global economy as well as on global stock markets. Never before has the global economic and financial system been so heavily dependent on U.S. economic and currency strength. Despite the longevity of the current U.S. upswing, the business cycle is still alive.

But if the Fed refuses to tighten, what else could possibly abort this expansion? We see a variety of potential spoilers: the trade balance, the dollar, the stock market, savings and, above all, slumping profit growth.

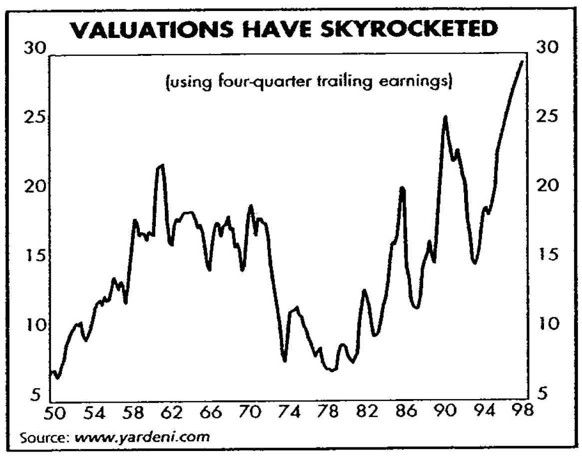


For more than a year, we have been warning that U.S. corporate profits are the Achilles heel of the raging bull market. Ever since the bull market began, it has been Wall Street's great bullish mantra that the surging stock prices perfectly mirror unprecedented "new era" efficiency gains, as evidenced by the spectacular growth of corporate earnings.

Every so often, we have exposed this as a self-promoting fable. The shareholder value miracle of the U.S. economy is a Wall Street fake. To make any economic sense, it would have to express itself primarily in higher earnings arising mainly from higher productivity growth. The U.S. profit boom of the past years has had many fathers (too many, actually), but this most important one — higher productivity growth — has been badly lacking.

PROFIT MENETEKEL

For several years, rapidly rising profits seemed to confirm Wall Street's "new era" mantra. In reality, though, these profits stemmed mainly from sharply falling corporate interest costs. As this decline in interest costs came to an end, so too, essentially, did this profits windfall. Yet heavy use of artificial profit-bolstering devices has successfully delivered the appearance of continuing bullish earnings growth. Reported earnings have been increasingly and dramatically overstated. Yet, the ugly reality is relentlessly coming to light. Even with all the cheating, actual profit growth has virtually disappeared.



These are the facts: Earnings per share in the S&P 500 Index are up against a year ago from $38.73 to $39.72, or 2.5 percent, and for the S&P Ind Index from $41.15 to $42.13, or 2.4 percent. Meanwhile the bull run over the last twelve months has sent valuations skyrocketing, reflected in soaring P/E ratios. For the S&P 500, its average soared from 19.79 to 28.27, or 43 percent, and for the S&P Ind Index from 21.94 to 30.81, or 40 percent.

Still, the market flatly refuses to take notice. We, of course, long ago realized that this bull market is primarily liquidity-driven, not earnings-driven. But should we conclude from this that traditional valuation measures don't matter anymore in this "new era"? Definitely not.

Profits are the essence of capitalism and stock markets. The bull maniacs may argue that traditional valuation measures are no longer valid in their fantasy world, but stagnating or declining profits are hard facts that can't be argued away. In the absence of strong corporate earnings growth, all the rigmarole about the great merits of shareholder value blatantly ceases to make any sense.

(continued on page 7)

Pair-Shared REITs Are About to Come Crashing Down

The financial excesses of the U.S. bubble economy are by no means limited to Wall Street. As we discuss on page 11, real estate on both coasts — and across the country — is experiencing a liquidity-driven mania. But no matter what the market, Wall Street inevitably gets a piece of the action, and in the case of commercial properties, that means REITs – real estate investment trusts.

There is a tremendous bubble in REITs, particularly in a special tax-advantaged kind called paired-share REITs. Here we will expose these instruments for the government fraud that they are and provide the best way to capitalize on the coming bursting of the paired-share REIT bubble.

Congress established REITs in 1960 to give small investors the opportunity to own interests in real property, similar to a "property mutual fund." REITs enjoy a significant tax advantage by being able to deduct dividends from their taxable income. Most REITs pay out all of their earned income as dividends and thus avoid the "double" taxation imposed on subchapter C corporations. REITs must be passive owners, receiving only property rent and certain other passive income.

In the late 1970s and early 1980s, certain REIT owners "stapled" or "paired" the stock of their REITs with an operating subchapter C corporation. Under a paired-share REIT structure, the two corporations trade as a single unit.

The REIT part of the paired entity acquires properties, such as hotels, retirement homes, or racetracks, that generally cannot be operated directly by a REIT. It then leases the properties to the paired subchapter C corporation, which is free to operate them unconstrained by the limitations that apply to REITs.

The grandfathering of a scam

In 1984 Congress, recognizing the tax avoidance potential of paired-share REITs, closed the loophole that had allowed them. But instead of eliminating all of the paired-share REITs, it allowed five of them to continue operating under that structure. Several of these have since been acquired by outside companies interested not in whatever business they happened to be in but in their special tax-advantaged operating structure.

The worst offender (or the smartest abuser of the privilege) has to be Starwood Lodging. Starwood has been on an acquisition frenzy, outbidding Hilton Hotels to buy the massive ITT franchise for a whopping $10.2 billion. Asked about the merger, Starwood CEO Barry Sternlicht told *The Wall Street Journal*, "There's value to our tax savings." Another Starwood exec stated, "all in all, Starwood Lodging estimates that it is saving about $150 million or so in annual taxes [on the ITT deal]."

That value to Starwood's "tax savings" should raise some red flags. There shouldn't be such "value," and the Treasury Department is catching on to this. Early this year it reported,

"While the market largely ignored the grandfathered entities for a significant period of time after 1984, recently promoters have begun exploiting these stapled REITs to accumulate large holdings of properties that could not be operated directly by a REIT. These entities have used their tax-favored grandfathered status to obtain a competitive advantage over others and to expand their operations greatly beyond the levels and types of businesses conducted in 1984."

The end of Starwood's glory days is near

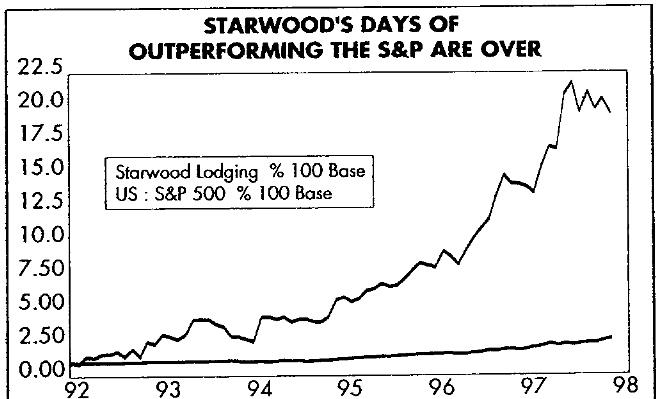
Judging by the share price action of the smaller paired-share REITs as shown in the chart on the following page, it is clear when the Treasury Department began to take an interest.

Starwood CEO Sternlicht rejects the criticism of outsiders. In a recent CNBC interview, he said the company will succeed with or without its status as a paired REIT. "People confuse our growth with our structure...We haven't grown because of a tax loophole," he said. But they have.

Unfortunately for Starwood shareholders, the company hasn't used its advantage to grow more profitable — only bigger. Now competitors are taking aim — Host Marriott Corp. (NYSE:HMT) recently announced it would reorganize as a real estate investment trust — and Congress is threatening to take away the paired-share REIT tax advantage.

In response to the Congressional risk, and the increased debt, S&P has downgraded the company's bonds to junk bond status. And despite Wall Street's incredible rally this year, the company's stock shares have stalled. When the rest of the world catches on to Sternlicht's Starwood Scam, and the shares finally break down, we'll go short.

Congress is upping the ante. Identical bills were recently submitted to the House and the Senate that, retroactive to March 26, 1998, would bar paired-share REITs from ever making any new acquisitions. Starwood is STILL cocky. Sternlicht is on record saying, "It doesn't matter if we lost the structure." You cannot keep a C-corp from doing business with a REIT. And that's at the end of the day; the only difference is Congress would say, 'Separate your shareholders,' and we would give them two different shareholder bases." This is known as paper-clipped REITs.



Source: *First Call World Equities (Tel: 33-1-44527854, Paris)*

This is Sternlicht and his tax advantage versus the U.S. Congress. All of the other paired-share REIT stocks have broken down technically in the last six months, even in the face of this strong bull market. But Sternlicht's jawboning has kept the share price of Starwood afloat.

We recommend shorting shares of Starwood (NYSE:HOT) when the world finally realizes that paired-REITs like Starwood won't last forever. We will define this as when the shares start to break down technically. We recommend initiating short positions in Starwood if the shares fall to $47, and doubling the size of your short position when the shares break below $44. (Starwood's Shares are currently trading at about $52.) Once the shares break down below $44, there are no fundamental or technical stopping points — look out below! — S.S. ■

(continued from page 5)

How could Wall Street so completely ignore this unfolding profit debacle? Very simply, just by conjuring it away with tricks and undeterred fantasy projections of a rapid return of "new era" profit growth. In contrast, we had expected and predicted that the foreseeable profit disappointments for the first quarter would at least temporarily spoil the bull run.

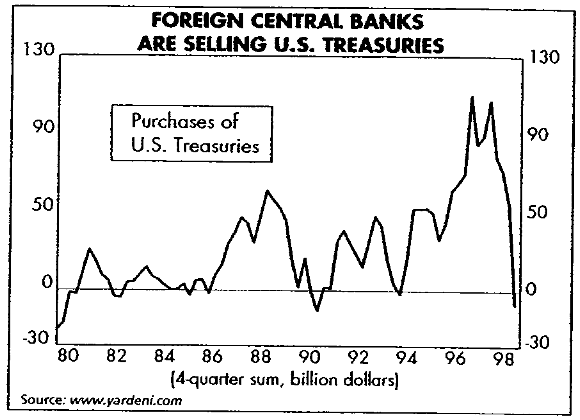
Actually, what has materialized is the worst profit performance during the present expansion. Reported earnings of 370 S&P companies are up a dismal 3.3 percent year-over-year. But this was turned into bullish news for the market with the argument that it did beat the last bottom's-up estimate of 0.5 percent. Very few cared to remember or to mention that the aggregate profit estimate for the quarter, recorded in early January, was 10.4 percent.

Still, there is a snag not to be overlooked: That is, long-term consensus expectations for profit growth remain unchanged. A wobble in the technical sector, and short-term problems for U.S. companies exposed to Asia will soon be reversed, say the analysts. In this light, profit estimates for the whole year of about ten percent, just as in 1997, have been fully maintained. It is explicitly and implicitly assumed that later this year the old profit boom will be back on track with an annualized gain of 15 percent. Most Wall Street pundits see in the economic data nothing that could seriously hurt corporate earnings. We do. First of all, it strikes us as particularly ominous that this profit squeeze has developed despite the very strong economic growth.

PROFITS LEAD THE WAY

The macroeconomic forces that herald an impending substantial deterioration in U.S. corporate profits are plain to see. What are these portents?

- the burgeoning trade deficit,
- a slowdown in corporate investment,
- the cessation of public deficit spending,
- some recovery in private savings from their all-time low,
- evaporating productivity growth and
- accelerated wage growth.



Of these six factors, the first four have in common that they reduce the revenues of the corporate sector, and, therefore, corporate earnings. But the single, most important factor is the rapidly widening trade deficit, as it directly undercuts not only U.S. GDP growth but also the currency and the financial markets. In its just published World Economic Outlook, the International Monetary Fund (IMF) projects a ballooning of the U.S. current-account deficit from $166 billion in 1997 to $210 billion in 1998 and further to $249 billion in 1999.

As ever, most commentators see no problem, dismissing the steep increase in the current account deficit with the comforting old argument that at roughly 2 per cent of GDP it remains trifling. Few seem to understand that this massive dollar outflow through the trade balance implies a savage profit and liquidity squeeze. Never mind, also, that the dollar plunged in 1995 when this deficit was only 1.8 percent of GDP. Will the rest of the world readily finance the soaring U.S. external deficit or not? That is the question. We think, it cannot and will not, and that the dollar is sure to fall.

A quick look at last year's U.S. capital inflows, and the changes in their composition, gives a sense of the heightened vulnerability of the dollar. Four points stand out:

- huge foreign direct investments in the U.S. are more than offset by U.S. direct investments abroad,
- the Asian crisis has turned heavy Treasury purchases by foreign central banks, exceeding $115 billion in 1996, into heavy net selling (see chart above),
- since early 1997 foreign private Treasury purchases have gradually receded from an exceptionally high level,
- decisive for the strong dollar were skyrocketing foreign purchases of U.S. stocks.

For the first time ever, foreign U.S. stock purchases have played a key part in the U.S. current-account financing and the dollar's strength. Since the second quarter of 1997, these purchases have been running at an annual rate of $80-90 billion, as against $10-15 billion in past years.

In the consensus view, the U.S. economy is in great shape. We have always warned that it is the great shape of a bubble economy largely propelled by financial asset inflation with strong spillover effects to consumer spending. A "bubble economy", in the strict sense of the term, develops whenever asset inflation transmits significant demand effects to the real economy. A bubble economy's essence is not price inflation for goods and services but the ensuing distortion of resource allocation. Asset inflation tends to go to far greater extremes than normal price inflation because the central banks, concerned only with price inflation indicators, keep money too loose for too long.

In Japan and the other Asian countries, these bubble effects went chiefly into overinvestment in industrial plant and commercial property. In the United States, in contrast, the asset inflation led predominantly to overconsumption, as consumers cashed in capital gains in the stock market to finance higher spending, with a declining savings ratio as its glaring flip-side.

HAS THE GLOBAL CYCLE TURNED?

In forecasting the US economy's further development, we attach crucial importance to the ongoing profit slump which, for the reasons explained, is sure to deteriorate. Though this profit slump has so far failed to slow the rise in stock prices, there is mounting evidence that it is fully effective in sharply slowing corporate fixed investment. Corporate investment cycles are closely tied in with corporate profit cycles.

These three major indicators — slumping profits, lower corporate investment and a widening trade deficit — herald no less than a drastic deceleration of the U.S. economy in the course of this year. Further implications will then depend on the reaction of the dollar and the stock market. Both can only be harmed by these trends, but how strongly they will react is the big question. A very sharp reaction could spell global havoc. Thinking it through, one begins to realize that the strong dollar and the booming stock markets have played a lifesaving role for the current global economic recovery. Once they wither, the world economy is in deep trouble.

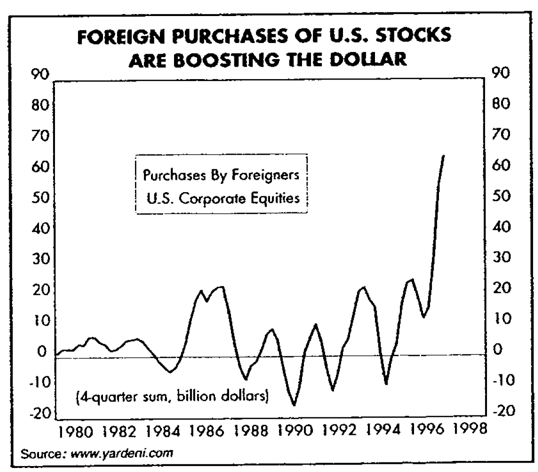
The standard scenario for the next U.S. economic slowdown and bear market in stocks is a rise in inflation triggering a spike in interest rates as the Fed hits the brakes. But this time, it may be slumping profits that start the recessionary ball rolling by pricking first the stock market bubble, with further nasty wealth effects upon consumer spending and further on corporate investment spending. Remember, this is a highly vulnerable bubble economy.

Such a U.S. scenario would unquestionably crush the dollar, and a falling dollar, in turn, augurs very badly for Europe — and the world's — economy and stock markets.

THE WALL STREET SPIN MACHINE WORKS OVERTIME

With keen focus on the aggressive and ever-expansive U.S. financial infrastructure that has so proliferated during this unprecedented bull market, we for the past year have described the credit system as "firing on all cylinders". Well, from the activities of the past several months we are compelled to discard our previous analogy. The distended group of American banks and savings and loans, Wall Street firms, mortgage lenders, traditional finance companies, REITs, sub-prime lenders, captive finance companies and insurance companies as well as the momentous but underappreciated credit machines of Fannie Mae, Freddy Mac and the Federal Home Loan Bank System have gone from "firing on all cylinders" to operating completely out of control. Literally, today when it comes to lending, borrowing, stock and bond issuance, and mergers and acquisitions, "anything goes".

For evidence of today's insanity one need look no further than the euphoria surrounding the recent spate of major bank mergers. In fact, three of the ten largest mergers in history have been recent bank mergers. The combination of Citibank with Travelers Group and BankAmerica with NationsBank were the first and second largest ever. The merger of Banc One with First Chicago ranked seventh. On a smaller scale but certainly consistent with the exuberance for financial businesses, aggressive insurance company Conseco is buying troubled Greentree Financial; First Union is acquiring aggressive sub-prime lender The Money Store; and Household International is purchasing competitor Beneficial Finance. While in the past deals priced at more than two times book "raised eyebrows", today's acquisitions are celebrated at four times book value and seemingly every company in the industry is now "in play". A new level of egregiousness is reached with Bank of New York's recent hostile bid for Mellon Bank at six times book value.



One thing is for sure, there is nothing like "merger mania" to keep attention conveniently focused away from the unbullish fact that lending margins continue to contract as the traditional banking business is faced with massive overcapacity and a dismal profit outlook. For a good example of the gaping divergence between stock market euphoria and actual underlying fundamentals, take a look at a BankAmerica and Citifcorp. At BankAmerica, the stock has gained 75 percent but during the past year while net income grew by only seven percent and net interest

income actually *declined* by $93 million as lending margins continue to shrink. At Citicorp net income increased by less than six percent, the stock has gained almost 60 percent.

Indeed, enormous overcapacity and resulting waning profitability is the catalyst for combinations, aggressive participation in the booming securities markets and today's stunning volume gains throughout. The outcome is the current monumental credit, securities and economic bubble.

A truly unbelievable volume of paper flooded out of Wall Street during the first quarter. According to Securities Data Corp., a record $472 billion in stock and bond securities were issued, 27 percent greater than the previous high set during 1997's third quarter. Debt sales grew 70 percent to $434 billion and stock sales rose 19 percent to $25.5 billion, the strongest first quarter in history. Long-term municipal issuance rose 76 percent from last year to $69 billion, the highest quarter of municipal issuance since 1993.

The feverish pace of mergers and acquisitions saw more than $236 billion of activity during the quarter, up 20 percent from last year's first quarter. Sales of junk bonds surpassed $40 billion, easily a quarterly record and 25 percent greater than total junk bond issuance in the Michael Milken heyday year of 1986. (New junk bond funds open almost weekly as the number now surpasses 400.) Today's exorbitant issuance, however, saw only a 13 percent increase in fees as margins shrink for investment banks as well.

Similarly, syndicated bank lending, much used for mergers and acquisitions, totaled $227.5 billion, also establishing a record for a first quarter. The total was eight percent greater than last year. The composition of this lending, however, became much more aggressive and, inevitably, problematic. Higher-yielding loans, those priced more than 250 basis points above the London interbank offered rate (LIBOR) rose 159 percent to almost $27 billion, and loans 125 basis points above LIBOR grew 142 percent to $75.5 billion. It is now commonly accepted that lending in the investment-grade market provides only marginal profits, at best.

Taking a look at the stock market, one sees the epitome of ever wilder speculation. Be it the senseless craze for internet stocks, the euphoria throughout the financial sector from the money center banks to the reckless sub-prime lenders, or the endless optimism in the face of evaporating profits throughout technology, investors more than ever buy on blind faith alone. Ignoring deteriorating profits generally, during March an all-time record $32.7 billion was invested in U.S. mutual funds. As profits wane, companies, nevertheless, buy back stock aggressively; witness the $1.8 billion each spent by each Intel and IBM for massive stock purchases during the first quarter. Last year, stock buybacks totaled $181 billion, up 82 percent on 1995.

While examples of Wall Street nonsense are commonplace, the six-point gain in reaction to IBM earning $1.06, "beating estimates" by one cent, was almost shocking. Never mind that earnings estimates had been sharply reduced after beginning the year at around $1.30. And never mind that net income for the quarter actually declined 13 percent from last year as sales grew a paltry 1.8 percent. Futhermore, hardware sales, where IBM has its highest margins and traditionally earns most of its profits, declined a noteworthy eight percent. Nevertheless, the stock has gained 12 percent so far this year and 55 percent for the past twelve months. As the financial infrastructure booms and corporate profits turn sour, the Wall Street "spin machine" works more diligently and, for now, more successfully than ever.

THE OTHER BUBBLE: REAL ESTATE

As the flood of liquidity powers stock market records, leveraged derivative speculating flourishes. Indeed, the final trading day prior to the April expiration saw record option trading at the American Stock Exchange. Looking to profit from the mania, long-time money managers Martin Zweig, Frank Russell, Mario Gabeli, and Dick Strong are apparently looking to sell interests in their money management operations. Talk also heightens that Goldman Sachs is considering going public, raising $20 billion for its partners.

And while the excesses permeating the stock market are now obvious to anyone looking, a more subtle but powerful real estate bubble gains further momentum. Housing starts for the first quarter were 8 percent higher than a very strong first three months of 1997. As construction, resales and pricing is strong nationally, similar to the late 1980's. Dramatic overheating is seen once again on the coasts. Comparing March activity to last year, Southern California sales ballooned 26 percent as prices gained over nine percent, led by a 14.5 percent rise in prices in Orange County. In fact, the median price paid for a Southern California home rose 2.3 percent in just one month! In the San Francisco Bay area, prices rose 13 percent, led by more than 20 percent gains in San Mateo and Santa Clara Counties.

In no way, however, are gains limited to residential properties. Apartments recorded price gains of almost nine percent last year and starts topped an annualized 400,000 during the fourth quarter for the first time in a decade. Commercial prices and rents, tracked by the National Real Estate Index, also rose nine percent annually during the fourth quarter, the 19th consecutive quarterly increase. Urban business district property prices rose 12.4 percent last year, slightly less than the 14.3 percent for suburban office markets. San Francisco, Orange County and San Jose saw spectacular average gains of 25 percent. With uncommon candidness, an officer of a California real estate company stated, "I liken it to the Dutch tulip bulb craze. People are bidding up prices with seemingly no regard for yields." On the East Coast, a similar boom is unfolding.

Today's real estate bubble is the natural offshoot of the U.S. credit, stock market and economic bubble and Wall Street appears determined to fuel even greater excesses. Powering the boom in the residential sector, Freddie Mac grew its balance sheet by over $32 billion during the first quarter alone. Over at Fannie Mae, outstanding mortgage-backed securities grew $21 billion. While current data is not yet available, we now learn that the Federal Home Loan system advanced $195 billion to banks and thrifts last year, 25 percent greater than in 1996. Moreover, as the latest hot product in home-equity lending is a ludicrous 150-percent-of-property-value loan, it is estimated that sub-prime originations will grow by 30 percent to over $160 billion this year, after expanding by two-thirds last year. For commercial properties, the REIT borrowing and buying boom continues and new REITs file for IPOs in droves.

Inarguably, the bubble economy's signs of wild excess are everywhere. For the month of March the M3 money supply grew by $62 billion. Money market assets now surpass $1.1 trillion having risen almost $200 billion from one year ago. According to estimates, foreign purchases of U.S. stocks are today running at four-times previous levels. U.S. sales by Mercedes-Benz rose 69 percent and for Lexus 43 percent. According to the most recent data from Johnson Redbook, retail sales are currently surging ten percent above last year. Consumer, business and investor confidence are at an all-time high. Across the board, the credit and asset bubbles not only flourish, they run completely out of control.

A NEW LIQUIDITY DELUGE FROM JAPAN?

Trying to discover some sense in the recent movements of global stock markets, we presume that the prolonged lull in the second half of last year largely reflected Asia-related caution. But initial worries turned into exuberance, as the market pundits successfully spread the opposite message that the Asian crisis, through lowering inflation and interest rates, was rather supportive of economic growth in the industrial countries.

In recent weeks, the bull maniacs drew further, strong inspiration from the news that the balance sheet of the Bank of Japan was showing a massive liquidity injection of about $130 billion into the banking system. Though it obviously failed to buoy the Tokyo market, commentators around the world triumphantly concluded that it would instead stimulate stock markets in the rest of the world. Apparently it did, but definitely not through any real liquidity effects.

This generous supply of liquidity to the Japanese market by the Bank of Japan had its root cause in hesitant foreign lending to Japanese banks. At the end of last year, Japanese banks had to pay a premium of 100 basis points on top of the Euro-yen rate, squeezing bank profitability. In the wake of this liquidity infusion, the Japan premium fell back to 40 basis points. It took place primarily through loans to the banks and the Deposit Insurance Corporation. What really happened was that the Japanese banks replaced a large part of their Euro-borrowing by borrowing from their own central bank. On the asset side of their balance sheet nothing changed.

Where is the connection with global liquidity and the bullish reaction of stock markets in the rest of the world? The naïve answer was that any increase in the already existing excess liquidity must essentially spill over abroad, and of course into stock market. The more sophisticated answer was that when Japanese banks cut their Euro-borrowing, the lending banks in Europe and America must essentially have more liquidity at their disposal, for which they must find new employment. And where else could that be than in the stock markets?

Frankly speaking, this whole story is conspicuous for the frightening primitiveness of thinking in questions of money prevailing in today's markets. In terms of Japanese bank reserves, this is admittedly an injection of immense magnitude, but in terms of the multi-trillion Euro-market, it is no more than a drop in the ocean — very unlikely to have the slightest effect on international bank lending or money flows.

CONCLUSION:

After a stunning rally over the first quarter, world stocks have suffered sudden, sharp declines. It is impossible to predict at this point how deep and protracted it will prove to be, but the vehemence of the setback is ominous.

Recent economic and financial news from Asia plainly reveal that the severity of the Asian crisis and its potential global repercussions have been grossly underestimated. Japan's deepening recession is a serious additional negative for the Pac Rim economies. In any case, the approaching reversal of the global bull run in stocks in inexorably predetermined by the looming U.S. profit recession. The Dow is every bit the bubble that the Japanese stock market was in the late 1980s.

In due time, the U.S. dollar will succumb to the widening trade deficit and weakening economic growth. A plunging stock market would send the currency reeling, with devastating effects on the European economy. By definition, a falling U.S. currency implies a strong euro.

We are sure that the global cycle has peaked, boding well for inflation and bonds but boding ill for profits and stock markets. ■

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